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The Tax Parameters of Inventory Valuation

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NOTES

The Tax Parameters of Inventory Valuation

INTRODUCTION

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.¹

The term "inventory," for tax accounting purposes, may be defined as the "costs or other values attributed to goods and services acquired or produced for sale, but not yet transferred or delivered to customers."² The manipulation of inventory values as a method of tax avoidance has been widely recognized,³ resulting in increased scrutiny of inventory valuation methods by the Internal Revenue Service (IRS).⁴ Accordingly, a working knowledge of inventory valuation bases is necessary for all taxpayers required to maintain inventories in order to avoid conflict with the IRS.⁵

¹ I.R.C. § 471.

² Skinner, *Valuation of Inventories: Choosing and Changing Methods*, 30 N.Y.U. INST. FED. TAX. 1769, 1770 (1972).

³ *Thor Power Tool Co. v. Comm'r*, 99 S. Ct. 773, 779-80 (1979); H.R. Doc. No. 140, 87th Cong., 1st Sess. 14 (1961); B. BITTKER & L. STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 842-44 (4th ed. 1972) [hereinafter cited as B. BITTKER]; Schwaigart, *Increasing IRS Emphasis on Inventories Stresses Need for Proper Practices*, 19 J. TAX. 66, 69 (1973); Skinner, *Inventory Valuation Problems*, 50 TAXES 748, 748-49 (1972).

⁴ B. BITTKER, *supra* note 3; Schwaigart, *supra* note 3, at 66.

⁵ I.R.C. § 471 and its regulations concerning inventory valuation have a significant impact upon business taxpayers. Any taxpayer engaged in a business in which the production, purchase or sale of merchandise is an income producing factor must use inventories in order to clearly reflect his income for tax purposes. Treas. Reg. § 1.471-1 (1958). An exception is made for taxpayers who utilize the completed contract method of tax accounting. Such taxpayers are not required to use inventories even if production, purchase or sale of merchandise is an income producing factor. Midland-

The potential for tax savings by varying inventory value can be ascertained readily by observing the effect of inventories on income.⁶ Gross income for an inventory taxpayer is the excess of sales over cost of goods sold.⁷ As the term implies, "cost of goods sold" is the value attributable to the items sold during the year. The key factor in this determination is the value of the inventory. Cost of goods sold equals the value of inventory held at the beginning of the taxable period, plus the cost of inventory acquired, less the value of inventory held at the end of the taxable period.⁸ In other words, the cost of goods sold for a taxable period is determined by comparing what the taxpayer held in inventory during the period with what he retained at the end of the period.

An example is appropriate to illustrate this point. No-Count Industries, a conventional manufacturing concern, had sales during the taxable period of \$150, but because it incurred costs in producing the items sold, all \$150 was not profit. No-Count's inventory at the beginning of the taxable year had a value of \$200 and No-Count acquired \$50 additional inventory during the period. If the value of ending inventory was determined to be \$120, the cost of goods sold for the period would equal \$130,⁹ and income for the year would be \$20.¹⁰ However,

Ross Corp. v. United States, 352 F. Supp. 1287, 1292 (N.D. Ohio 1972), *aff'd*, 485 F.2d 110 (6th Cir. 1973); Rev. Rul. 59-329, 1959-2 C.B. 138. Furthermore, any taxpayer required to use inventories must report taxable income on the accrual basis. Treas. Reg. § 1.446-1(c)(2)(i) (1957). These rules affect a range of business taxpayers from the large automobile manufacturers to the local "mom-and-pop" groceries. It even covers funeral homes. See *Wilkinson-Beane, Inc. v. Comm'r*, 420 F.2d 352 (1st Cir. 1970), where caskets used in providing funeral services were "merchandise" and "income producing factors" for purposes of determining whether the taxpayer was required to use inventories for tax purposes.

⁶ See, e.g., B. BITTKER, *supra* note 3, at 843-44; J. MAURIELLO, *BUSINESSMAN'S FEDERAL TAX GUIDE* 235-36 (1st ed. 1971) [hereinafter cited as J. MAURIELLO].

⁷ *Thor Power Tool Co. v. Comm'r*, 99 S. Ct. 773, 780 n.9 (1979); Treas. Reg. § 1.61-3(a) T.D. 7285, 1973-2 C.B. 163, 164.

⁸ "Cost of Goods Sold equals Opening Inventory, plus Cost of Inventory Acquired, minus Closing Inventory." *Thor Power Tool Co. v. Comm'r*, 99 S. Ct. 773, 780 n.9; e.g., *Ries v. United States*, 172 F. Supp. 929, 933 n.6 (E.D. Pa. 1959); D. KIESO & S. WEYGANDT, *INTERMEDIATE ACCOUNTING* 312 (1st ed. 1974).

⁹ Beginning Inventory (\$200) plus Inventory Acquired During the Period (\$50) less Ending Inventory (\$120) equals Cost of Goods Sold (\$130). See note 8 and accompanying text *supra* for a discussion of this formula.

¹⁰ Sales (\$150) less Cost of Goods Sold (\$130) equals Income (\$20). See note 7 and accompanying text *supra* for a discussion of this formula.

if No-Count could alter the value of ending inventory to \$110, cost of goods sold would be \$140,¹¹ and income for the period would be only \$10.¹² Accordingly, the lower the value attributed to ending inventory, the higher the cost of goods sold figure. Reducing the value of ending inventory can, therefore, result in a corresponding reduction of taxable income.¹³

Reduction of ending inventory value does not eliminate income, but defers it to the period in which the inventory is liquidated. In No-Count's situation, reducing the value of ending inventory by \$10 resulted in reduction of taxable income by a like amount.¹⁴ When No-Count eventually sells the \$110 worth of ending inventory, which had originally been valued at \$120, the company will realize a gain of \$10 more than it would have recognized had the original valuation been retained.¹⁵

The resulting deferral of income can provide two economic benefits for the taxpayer. First, deferral of the income causes a proportionate deferral of the tax on that income. The taxpayer, therefore, has the use of money, equal to the tax savings had by reporting less income, from the reporting date until the date the inventory is actually sold.¹⁶ "The taxpayer, in effect, borrows the amount of the tax from the federal government without paying interest."¹⁷ Second, further savings are realized if the applicable tax rate in the year of deferral is greater than that applied in the year the inventory is liquidated.¹⁸

I. BASIC REQUIREMENTS FOR AN INVENTORY VALUATION METHOD

Before any method of inventory valuation may be used for tax purposes it must meet two requirements. The method

¹¹ Beginning Inventory (\$200) plus Inventory Acquired During the Period (\$50) less Ending Inventory (\$110) equals Cost of Goods Sold (\$140).

¹² Sales (\$150) less Cost of Goods Sold (\$140) equals Income (\$10).

¹³ "A variation in inventory pricing has a one-for-one impact on net income before taxes . . ." H. BARDEN, *THE ACCOUNTING BASIS OF INVENTORIES*, ACCOUNTING RESEARCH STUDY NO. 13, at 1 [hereinafter cited as H. BARDEN].

¹⁴ See notes 9-13 and accompanying text *supra* for the computations supporting this statement.

¹⁵ Assuming Sales of \$150; Sales (\$150) less Cost of Goods Sold (\$110) equals Income (\$40). However, Sales (\$150) less Cost of Goods Sold (\$120) equals Income (\$30).

¹⁶ J. MAURIELLO, *supra* note 6, at 235.

¹⁷ *Id.*

¹⁸ *Id.*

must: (1) conform "as nearly as may be to the best accounting practice;" and (2) clearly reflect income.¹⁹

A. *Best Accounting Practice*

The Treasury Regulations provide that "inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business."²⁰ This standard has been interpreted to require conformity with generally accepted accounting principles.²¹ Based on this construction, any determination as to whether a method conforms as nearly as may be to the best accounting practice necessarily requires reference to generally accepted inventory accounting principles.²² Since generally accepted accounting principles are dictated by the accounting profession, that profession determines the criteria necessary to resolve the "conformity" issue.²³

B. *Clear Reflection of Income*

A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income provided all items of gross income and expense are treated consistently from year to year.²⁴

¹⁹ I.R.C. § 471; Treas. Reg. § 1.471-2(a)(1)-(2) (1958).

²⁰ Treas. Reg. § 1.471-2(b), T.D. 7285, 1973-2 C.B. 163, 164.

²¹ "[I]t must comply 'as nearly as may be' with the 'best accounting practice,' a phrase that is synonymous with 'generally accepted accounting principles.'" *Thor Power Tool Co. v. Comm'r*, 99 S. Ct. 773, 781 (1979). "[A]n inventory valued in accordance with generally accepted accounting principles may be considered as one that conforms 'as nearly as may be to the best accounting practice in the trade or business.'" *E.W. Bliss Co. v. United States*, 224 F. Supp. 374, 382 (N.D. Ohio 1963), *aff'd*, 351 F.2d 449 (6th Cir. 1965).

²² The accounting profession's official statement on inventory valuation is found in AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, INC., FINANCIAL ACCOUNTING STANDARDS Ch. 4 (Accounting Research Bulletin No. 43, 1976) [hereinafter cited as A.R.B. No. 43].

²³ Generally accepted accounting principles are created primarily through the American Institute of Certified Public Accountants.

²⁴ Treas. Reg. § 1.446-1(a)(2) (1957). Note that until amended by T.D. 7285, 1973-2 C.B. 163, Treas. Reg. § 1.471-2 contained this language: "An inventory that can be used under the best accounting practice in a balance sheet showing the financial

The IRS assigns greater weight to consistent application than to the actual method applied, "so long as the method or basis used is in accord with §§ 1.471-1 through 1.471-11"²⁵ of the Treasury Regulations. Essentially, any method prescribed by the regulations will clearly reflect income if consistently and appropriately applied. As for those methods not prescribed by the regulations, consistency alone is not sufficient unless the method in other respects clearly reflects income.²⁶ An erroneous method does not become acceptable merely because it is used consistently.²⁷

No method of accounting, including any inventory valuation method, is acceptable "unless, in the opinion of the Commissioner, it clearly reflects income."²⁸ The courts have given the Commissioner of Internal Revenue broad discretion in determining whether a particular method meets this standard.²⁹ "It is not the province of the court to weigh and determine the

position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income." This deletion implies that the determination of whether an inventory method will clearly reflect income depends upon its effect on income determination rather than balance sheet presentation. "It is clear, therefore, that the above modification of the inventory regulations is intended to place less emphasis on the best accounting practice for balance sheet presentation purposes and more emphasis on the best accounting practice for income measurement purposes." Cox, *Inventory Valuation Problems*, 23 TUL. TAX INST. 102, 104 (1974).

²⁵ Treas. Reg. § 1.471-2(b), T.D. 7285, 1973-2 C.B. 163, 164.

The term consistency, when applied to inventories, has a number of components. The method of valuation must be consistent from year to year; the opening inventory of one year must correspond to the closing inventory of the preceding year; and the items comprising inventory must be consistent from year to year.

Summa, *Inventory Valuation Problems, Including Consideration of Related Tax and Accounting Treatment*, 21 N.Y.U. INST. FED. TAX 1183, 1184 (1963).

²⁶ Photo-Sonics, Inc. v. Comm'r, 357 F.2d 656, 658 n.2 (9th Cir. 1966) ("consistency alone cannot satisfy the requirement that there be a clear reflection of income"); Fame Tool & Mfg. Co. v. Comm'r, 334 F. Supp. 23, 30 (S.D. Ohio 1971) ("[T]he consistent use of an erroneous method does not justify its continued use."); All-Steel Equipment, Inc. v. Comm'r, 54 T.C. 1749, 1756 (1970) *mod.*, 467 F.2d 1184 (1972) ("[T]he significance of consistent use is limited to the situation in which the method chosen is acceptable.")

²⁷ 357 F.2d at 658; 334 F. Supp. at 30; 54 T.C. at 1756.

²⁸ Treas. Reg. § 1.446-1(a)(2) (1957).

²⁹ Thor Power Tool Co. v. Comm'r, 99 S. Ct. 773, 781 (1979) ("wide discretion"); United States v. Catto, 384 U.S. 102, 114 (1965) ("broad discretion"); Comm'r v. Hansen, 360 U.S. 446, 467 (1959) ("broad powers"); Lucas v. American Code Co., 280 U.S. 445, 449 (1930) ("[m]uch latitude").

relative merits of systems of accounting.”³⁰ Thus, the Commissioner’s interpretation of what clearly reflects income “should not be interfered with unless clearly unlawful.”³¹

Since there is no precise standard delineating what constitutes a clear reflection of income, the Commissioner’s decision is based on the facts and circumstances peculiar to each case.³² Consequently, in challenging the Commissioner’s decision the taxpayer bears a heavy burden of proof. The Commissioner’s decision will not be set aside unless clearly arbitrary.³³ Thus, while the accounting profession’s guidelines essentially dictate whether a method of inventory valuation conforms as nearly as may be to the best accounting practice in the trade or business, the IRS has primacy in determining whether a particular method most clearly reflects income.

II. ACCEPTABLE METHODS OF INVENTORY VALUATION

Any inventory valuation method used for tax purposes must satisfy the aforementioned standards. The two primary methods of inventory valuation specifically approved by the treasury regulations are (1) cost and (2) lower of cost or market.³⁴ The ability to value inventory at a figure other than its

³⁰ *Brown v. Helvering*, 291 U.S. 193, 204-05 (1934).

³¹ *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930).

³² “[W]hether a method of accounting clearly reflects income is to be determined on the basis of the particular facts and circumstances of each case” *Lincoln Electric Co. v. Comm’r*, 54 T.C. 926, 933 (1970), *aff’d*, 444 F.2d 491 (1971).

³³ “When the Commissioner has made such a determination, the taxpayer faces a heavy burden of proof to establish that it was arbitrary or an abuse of discretion.” *Comm’r v. Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738, 743 (2nd Cir. 1968). *See also* *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930); *Altec Corp. v. Commissioner*, 36 T.C.M. (CCH) 1795, 1808 (1977). L977-438.

³⁴ *Treas. Reg.* § 1.471-2(c). Even if the taxpayer has adopted one of the primary valuation methods there is a superseding valuation applicable where the inventory is “unsaleable at normal prices or unusable in the normal way because of damage, imperfections, shopwear, changes of style, odd or broken lots, or other similar causes.” *Id.* This valuation is applied because the items in inventory have become physically less desirable and such physical undesirability naturally makes the inventory’s value less than when the goods were in a saleable and usable condition. However, *Treas. Reg.* § 1.471-2(c) requires that the taxpayer bear the burden of proof in this matter.

To meet this burden of proof there must be a comparison between the taxpayer’s normal and “subnormal” goods so that a departure from the norm can be recognized. *Cleveland Auto. Co. v. United States*, 70 F.2d 365, 369 (6th Cir. 1934), *cert. denied*, 293 U.S. 563 (1934). Thus, goods physically equivalent to normal goods, such as items

cost is characteristic of the lower of cost or market method and its offspring, the net realizable value approach. First, however, it is important to understand the mechanics of the cost method because it is an integral part of the lower of cost or market method.

A. *The "Cost" Method*

The cost method of inventory valuation is governed by Treas. Reg. § 1.471-3.³⁵ Cost, for accounting purposes, means "the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location."³⁶

In applying the cost concept, tax law³⁷ requires that inventory acquired during a period be valued at its invoice price less any discounts, but including "transportation or other necessary charges incurred in acquiring possession of the goods."³⁸ Therefore, acquired inventory is valued at the actual cost of its procurement. Assuming a net purchase price of \$80 for the item and freight costs of \$10, the item would be valued at \$90 under the cost approach. When inventory is carried over from one taxable period to the next, the value of that inventory at the beginning of the new period must equal the value of the closing inventory for the prior period.³⁹ For example, if inventory on the final day of the preceding year was valued at \$110, begin-

in excess of current demand, cannot be the object of this type of valuation. *Thor Power Tool Co. v. Comm'r*, 64 T.C. 154, 171 (1975), *aff'd*, 563 F.2d 861 (7th Cir. 1977), *aff'd*, 99 S. Ct. 773 (1979). Since goods merely in excess of demand are normal, they would compete in the same market, which proves they are not subnormal. *Id.*

³⁵ Amended by T.D. 7285, 1973-2 C.B. 163, 164.

³⁶ A.R.B. No. 43, *supra* note 22, Ch. 4, Stmt 3, at 16.

³⁷ Treas. Reg. § 1.471-3 (1958), amended by T.D. 7285, 1973-2 C.B. 163, 164.

³⁸ Treas. Reg. § 1.471-3(b) (1958).

³⁹ "In the case of merchandise on hand at the beginning of the taxable year, [cost means] the inventory price of such goods." Treas. Reg. § 1.471-3(a) (1958).

The cost of inventory on hand at the end of the year becomes the cost of opening inventory for the next succeeding year. Thus, if an expense is properly allocable to the cost of acquiring the inventory on hand at the end of the year, it is not deductible in the year it is incurred; in effect, the expense is deferred until the year in which such inventory is sold.

All-Steel Equip., Inc. v. Comm'r, 54 T.C. 1749, 1751 (1970).

ning inventory for the current year must be valued at \$110.

The value of finished merchandise or merchandise in production must include the cost of raw materials used in connection with the product, direct labor expenses and "indirect production costs incident to and necessary for the production of the particular article."⁴⁰ The most elusive of these cost elements is the indirect production cost.⁴¹ The allocation of that element has been hotly disputed.⁴² Three alternatives for allocating these indirect production costs to inventory are: (1) prime costing; (2) direct costing; and (3) absorption costing.

The "prime costing" method of indirect production cost allocation does not include indirect production costs in the inventory valuation.⁴³ Instead, inventory value is the sum of direct labor and material costs attributable to that inventory, requiring all indirect costs to be charged to income in the year incurred.⁴⁴ This method of allocating indirect costs is not in accordance with generally accepted accounting principles⁴⁵ and courts have held it improper for tax purposes.⁴⁶ The regulations now provide that prime costing cannot be used in valuing inventories to determine taxable income.⁴⁷

⁴⁰ Treas. Reg. § 1.471-3(c), T.D. 7285, 1973-2 C.B. 163, 164.

⁴¹ J. FREMGEN, ACCOUNTING FOR MANGIERAL ANALYSIS 18 (2d ed. 1972) provides an excellent discussion of direct and indirect costs of production.

Certain costs can be traced logically and practically in their entirety to a costing unit; there is a directly determinable relationship. Such costs are called *direct costs*. . . . Other costs can be identified partially with a costing unit, but not entirely. That is, they relate to the unit under study; but they also relate to other costing units. The amount of the cost which is properly identifiable with one unit is not readily determinable. Such costs are termed *indirect costs*.

⁴² See notes 43-54 *infra* and accompanying text for a discussion of these problems.

⁴³ "[P]rime cost" accounting allocates only the cost of direct labor and direct materials to the cost of work in process inventory." *Fame Tool & Mfg. Co. v. Comm'r*, 334 F. Supp. 23, 30 (S.D. Ohio 1971). *Accord*, *Photo-Sonics, Inc. v. Comm'r*, 357 F.2d 656, 657 (9th Cir. 1966).

⁴⁴ 357 F.2d at 657; 334 F. Supp. at 30.

⁴⁵ "It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure." ARB No. 43, *supra* note 22, Ch. 4, Stmt. 3, Discussion n.5, at 17. *Accord*, *Photo-Sonics, Inc. v. Comm'r*, 357 F.2d 656, 658 (9th Cir. 1966); *All-Steel Equip., Inc. v. Comm'r*, 54 T.C. 1749, 1752 (1970).

⁴⁶ *Photo-Sonics, Inc. v. Comm'r*, 357 F.2d 656 (9th Cir. 1966); *All-Steel Equip., Inc. v. Comm'r*, 54 T.C. 1749 (1970); *Dearborn Gage Co. v. Comm'r* 48 T.C. 190 (1967).

⁴⁷ Treas. Reg. § 1.471-2(f)(7), T.D. 7285, 1973-2 C.B. 163, 164, includes among the methods not in accord with the regulations: "Treating all or substantially all indirect

The "direct costing" method distinguishes between fixed costs⁴⁸ and variable costs⁴⁹ in the allocation of indirect costs of production. Under the "direct costing" method, direct labor, direct materials and variable indirect costs are included in the inventory value.⁵⁰ Only fixed indirect costs are charged directly to income in the period they are incurred. While courts differed as to the acceptability of this method for tax purposes,⁵¹ the regulations now preclude its use.⁵²

"Absorption costing" is the favored method of allocating indirect production costs for inventory purposes.⁵³ It requires that a proportionate amount of most indirect costs, whether fixed or variable, be included in the value of the inventory item.⁵⁴ Treas. Reg. § 1.471-11 requires that all taxpayers en-

production costs (whether classified as fixed or variable) as period costs which are currently deductible. This method is generally referred to as the 'prime cost' method."

⁴⁸ *Fixed costs* remain constant in total regardless of changes in volume. . . . For example, the monthly rent on a computer installation may be \$24,000 regardless of how many hours the equipment is used per month. . . . There is an inverse relationship between volume and fixed cost per unit of volume. Hence, *fixed costs are constant in total as volume changes but vary per unit of volume inversely with volume.*

J. FREMGEN, *supra* note 41, at 23-24.

⁴⁹ *Variable costs* are those costs which vary in total in direct proportion to changes in volume. Successive increases in units of volume result in parallel and proportionate increases in variable costs. Similarly, decreases in volume produce proportionate cost decreases. . . . Thus, *variable costs vary in total in direct proportion to volume and, consequently, are constant per unit of volume.*

Id. at 23.

⁵⁰ "In . . . 'direct costing,' direct labor, materials, and *variable* overhead factory expenses are allocated to work in process inventory cost." *Fame Tool & Mfg. Co. v. Comm'r*, 334 F. Supp. 23, 30 (S.D. Ohio 1971).

⁵¹ *Photo-Sonics, Inc. v. Comm'r*, 357 F.2d 656, 658 (9th Cir. 1966) (in dicta, the court stated that it "may be" an acceptable method); *Geometric Stamping Co. v. Commissioner* 26 T.C. 301 (1956) (allowed its use but primarily based its decision upon the taxpayer's prolonged and consistent use without IRS objection).

⁵² Treas. Reg. § 1.471-2(f)(6), T.D. 7285, 1973-2 C.B. 163, 164 includes among the methods not in accord with the regulations:

Segregating indirect production costs into fixed and variable production cost classifications (as defined in § 1.471-11(b)(3)(ii)) and allocating only the variable costs to the cost of goods produced while treating fixed costs as period costs which are currently deductible. This method is commonly referred to as the "direct cost" method.

⁵³ *Fame Tool & Mfg. Co., Inc. v. Comm'r*, 334 F. Supp. 23, 30 (S.D. Ohio 1971); Treas. Reg. § 1.471-11(a), T.D. 7285, 1973-2 C.B. 163, 164-5.

⁵⁴ 334 F. Supp. at 30; Treas. Reg. § 1.471-11(a),(c),(d), T.D. 7285, 1973-2 C.B. 163, 164-70.

gaged in manufacturing or production use the full absorption method, and lists the classification and "costing" of most conceivable indirect costs.

Some inventory must be valued at cost for tax purposes. For example, goods on hand or in process must be valued at cost if their use is for delivery upon a firm sales contract⁵⁵ entered into before the date of inventory valuation, where the contract provides for a fixed sales price and the taxpayer is protected against actual loss.⁵⁶ The inventory must be valued at cost not only when the contract specifically provides for protecting the seller against loss, but also when evidence indicates that the sale price will be adequate to cover all direct and indirect costs of manufacture.⁵⁷ Such inventory must be valued at cost even if the taxpayer uses the lower of cost or market method.⁵⁸

In industries where the cost rules of Treas. Reg. § 1.471-3 may not be applied, the costs may be approximated if reasonable and in conformity with that industry's trade practices.⁵⁹ This exception includes farmers and livestock raisers,⁶⁰ retail

⁵⁵ Treas. Reg. § 1.471-4(a)(2) (1958). The regulation says that firm sales contracts are those not legally subject to cancellation by either party.

A "firm sales" contract is one which obligates the seller to deliver to the buyer at some stated future time the merchandise specified in the accepted order and obligates the buyer to pay to the seller the price specified in that order. . . .

Ordinarily, a contract to sell to another at a specified price all that the buyer may require for his business during a certain period, in return for which the buyer promises to buy exclusively from the seller, is a valid contract, as both parties are mutually bound. A contract to sell and a promise to purchase a specific quantity of goods for future delivery, at a price to be determined in the future is also a valid contract. Nevertheless, for our purpose, a contract for future delivery which does not specify the price to be paid is absolutely fatal to the existence of a "firm sales" contract. This is also true where the quantity to be sold is not specified, unless it can be determined from sources which reveal approximately the quantity involved.

Feigenbaum, *Valuation of Inventories Covered by "Firm Sales" Contracts*, 6 TAXES 330, 331 (1928).

⁵⁶ Treas. Reg. § 1.471-4(a)(2) (1958).

⁵⁷ "That such a condition may occur in relatively few instances is no justification for ignoring the plain terms of the regulations." *E. W. Bliss Co. v. United States*, 224 F. Supp. 374, 384-85 (N.D. Ohio 1963), *aff'd*, 351 F.2d 449 (6th Cir. 1965).

⁵⁸ Treas. Reg. § 1.471-4(a)(2) (1958).

⁵⁹ Treas. Reg. § 1.471-3(d) (1958).

⁶⁰ The regulations prescribed for livestock raisers and other farmers for inventory purposes are found in Treas. Reg. § 1.471-6 (1958).

merchants using the "retail method"⁶¹ and miners and manufacturers, who from a single process or uniform series of processes produce a product of two or more kinds, sizes or grades.⁶²

Generally accepted accounting principles⁶³ do not condone the cost approach as a method of valuing inventory.⁶⁴ Accounting principles require a lower valuation of "market" when the utility of the item is no longer as great as its cost.⁶⁵ Under a pure cost method of inventory valuation, the inventory would be valued at cost regardless of the utility of the goods.⁶⁶ Despite this principle, the regulations expressly approve of the cost method,⁶⁷ stating that it conforms as nearly as may be to the best accounting practice in the trade or business.⁶⁸ This approval seems inconsistent with the Supreme Court's statement in *Thor Power Tool Co. v. Commissioner* that the best accounting practice is equivalent to generally accepted accounting principles.⁶⁹ Perhaps the Court meant that the best accounting practice includes, but is not limited to, generally accepted accounting principles.

B. *The Lower of Cost or Market Method*

Rules applicable to the lower of cost or market method for tax purposes may be found in Treas. Reg. § 1.471-4.⁷⁰ The

⁶¹ Treas. Reg. § 1.471-3(d) (1958). Retailers using the retail method are provided for in Treas. Reg. § 1.471-8 (1958).

⁶² Treas. Reg. § 1.471-3(d) (1958). Such miners and manufacturers are considered in Treas. Reg. § 1.471-7 (1958).

⁶³ See A.R.B. No. 43, *supra* note 22, at Ch. 4.

⁶⁴ A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market.

A.R.B. No. 43, *supra* note 22, Ch. 4, Stmt 5, at 17.

⁶⁵ *Id.*

⁶⁶ Treas. Reg. § 1.471-3 (1958), amended by T.D. 7285, 1973-2 C.B. 163, 164.

⁶⁷ *Id.*

⁶⁸ See Treas. Reg. § 1.471-2(c) (1958).

⁶⁹ See note 21 *supra* for a discussion of the court's view.

⁷⁰ Treas. Reg. § 1.471-4 (1958) provides as follows:

§ 1.471-4. Inventories at cost or market, whichever is lower.

(a) Under ordinary circumstances and for normal goods in an inventory,

unique feature of this method is the ability to value inventory at less than its actual cost.⁷¹ Lower of cost or market means that each item in inventory is computed at both cost and market, with the lower of the two values being used to value all the inventory.⁷²

Cost, in the lower of cost or market context, means the same as determined under Treas. Reg. § 1.471-3.⁷³ Market, for normal goods under ordinary circumstances, is the current bid price as of the inventory valuation date.⁷⁴ Bid price is the replacement cost of the item on the inventory date,⁷⁵ or what it

“market” means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases —

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, *under which the taxpayer is protected against actual loss*, which goods must be inventoried at cost.

(b) *Where no open market exists or where quotations are nominal*, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, *the inventory may be valued at such prices less direct cost of disposition*, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article. (emphasis added).

⁷¹ Treas. Reg. § 1.471-4(c).

⁷² *Id.*

⁷³ See note 36 *supra* and accompanying text for the definition of “cost”.

⁷⁴ Treas. Reg. § 1.471-4(a) (1958).

⁷⁵ *Thor Power Tool Co. v. Comm’r*, 99 S. Ct. 773, 782 (1979); *D. Loveman & Son Export Corp. v. Comm’r*, 34 T.C. 776, 796 (1960), *aff’d*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962); A.R.B. No. 43, *supra* note 22, Ch. 4, Stmt 6, at 18. There are two exceptions to the use of bid price as the market value of inventory in the taxpayer’s hands:

would cost the taxpayer to purchase⁷⁶ or reproduce⁷⁷ the item

Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the [bid price], the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as clearly reflecting the market.

Treas. Reg. § 1.471-4(b) (1958).

⁷⁶ Valuation at purchase price is the method preferred by the IRS. G.C.M. 9401, X-1 C.B. 102, 105 (1931).

[P]urchased or produced goods in the inventory of a manufacturer in a form salable on the open market on the inventory date should be valued at the current bid prices prevailing in the open market for like goods on that date, and . . . any such goods . . . which have not reached a form salable on the open market should be valued at the current bid prices prevailing on the inventory date for goods of the preceding salable form, plus the necessary labor and burden attaching up to the state in which the goods are found on the inventory date.

Id.

⁷⁷ Valuation at cost of reproduction is described in G.C.M. 9401, X-1 C.B. 102, 103 (1931):

One view is to the effect that the regulations require the valuation of goods at various stages of manufacture, in the inventory of a manufacturer, at the current bid prices prevailing on the inventory date for goods similar to the form in which the manufacturer purchases his raw material, to which there is to be added, a valuation, at current bid prices prevailing on the inventory date, of the necessary labor and burden connected with the goods to bring them to the stage of manufacture in which they are found on the inventory date. The "market" valuation resulting therefrom is a reproductive valuation representing the estimated cost on the inventory date of replacing through manufacture the specific goods in the inventory on the inventory date.

While the IRS felt that valuation of purchase price should be used whenever possible, it stated that reproduction cost could be used where valuation at purchase price was impractical:

Under [our] view only such goods as have not reached a form saleable on the open market between the time of the original purchase of the raw material and the inventory date should be valued on the basis of so-called reproductive cost, or estimated cost of replacement through manufacture of the specific goods on the inventory date, including also goods in process or finished goods for which there are no open market quotations on the inventory date.

Id. at 104.

when the lower of cost or market comparison is made. Since bid price is dependent upon the taxpayer's ability to purchase or reproduce the item rather than his ability to sell it on the open market, the bid price must be representative of a normal purchase or reproduction and must be for the quantities usually acquired by the taxpayer.⁷⁸

For example, assume that No-Count Industries has finished goods in its inventory which were produced at a cost of \$100 per unit. Because certain costs of production have declined, No-Count can now replace these goods at a cost of \$90. Since this bid price is less than the cost, the items would be valued at market. The "write-down" or inventory value reduction of \$10 would result in a \$10 increase in the cost of goods sold for the period with a like reduction of taxable income.⁷⁹ The unique feature of this write-down is that it allows No-Count to deduct an unrealized loss.⁸⁰ The write-down is a well recognized exception to the requirement of reporting only closed transactions for tax purposes.⁸¹

One theory supporting this lower replacement cost valua-

In summarizing the ruling the IRS held:

The reproductive cost method is entirely appropriate as to goods in process which have not reached a form salable on the open market between the time of the original purchase of the raw material and the inventory date, and as to goods in process or finished goods where there are no open market quotations therefor.

Id. at 106.

⁷⁸ Treas. Reg. § 1.471-4(a).

⁷⁹ See notes 9-15 *supra* and accompanying text for a discussion of the relationship between reduction in inventory values and taxable income.

⁸⁰ *Sharp v. Comm'r*, 224 F.2d 920, 924 (6th Cir. 1955). The court stated the principle as follows:

[I]t is . . . "well recognized that the method of valuing inventory at the lower of cost or market is an instance where the tax law permits the deduction of an unrealized loss, and it is a recognized exception to the necessity of reflecting in income tax returns only closed transactions."

Space Controls, Inc. v. Comm'r, 322 F.2d 144, 148 (5th Cir. 1963) provided an example of the mechanics of this principle:

The validity of this is illustrated by considering the simplified case of a trader of a commodity, such as fuel oil, which has a readily ascertainable, lively market. Though stock on hand procured earlier at a greater cost will not be sold and the loss thereby "realized" until the succeeding year, it is plain that it may be written down at the year's end to reflect the market price. This is true even though in fact no "loss" ever occurs because of an intervening subsequent rise in market value.

⁸¹ 322 F.2d at 148; 224 F.2d at 924.

tion is the existence of a direct relationship between replacement cost and the sales price of an inventory item.

The cost-or-market basis of inventory pricing conforms with an old rule of accounting conservatism often stated as follows: Anticipate no profit and provide for all possible losses. If market purchase prices decline, it is assumed that selling prices will decline with them; reducing the inventory valuation to market purchase price reduces the profit of the period when the cost price decline took place and transfers the goods to the next period at a price which will presumably permit the earning of a normal gross profit on their sale. If the market purchase price increases, the inventory is valued at cost so that a profit will not be anticipated.⁸²

This approach presumes that a drop in market for the raw components is indicative of a drop in market for the finished product. However, changes in replacement costs are not always conclusive evidence of relative changes in selling price and therefore are not always indicative of a decline in value.⁸³ Still, while a lower replacement cost may not always result in a loss upon the sale of an item, it does have that effect in many cases, and replacement cost seems to be the most objective estimate of this loss.⁸⁴

Another justification for valuing the inventory at the lower bid price is premised on the assumption that the taxpayer has suffered an economic loss when he can replace the item for less than its original cost. In such a case, had the item been produced on or subsequent to the inventory date, the taxpayer would have more funds to cover other needs. Thus the taxpayer could be said to have lost savings and this loss is reflected in the write-down.

⁸² *Thor Power Tool Co. v. Comm'r*, 64 T.C. at 169; *D. Loveman & Son Export Corp. v. Comm'r*, 34 T.C. at 798 (citing *Finney & Miller, Principles of Accounting* (Intermediate) 251 (5th ed. 1958)).

⁸³ "Several early critics of the rule argued that changes in replacement costs are not conclusive evidence of selling price changes and are therefore not sufficient evidence of probable loss in utility value." H. BARDEN, *supra* note 13, at 105.

⁸⁴ "Proponents of the replacement cost basis admitted that declines in replacement cost may not always result in realization losses but argue that they do in many cases. Proponents also stressed the objectivity of the replacement cost basis." *Id.*

C. *The Net Realizable Value Method*

Stating inventory at its net realizable value is based on the concept of limiting the value of an item to the amount one can expect to receive in exchange for it even though it might cost more than that now to replace it. This valuation method avoids overstatement of expected economic benefits when the utility⁸⁵ of the item has declined.⁸⁶

Current accounting practice permits the use of net realizable value as the maximum valuation of market where the lower of cost or market method is utilized.⁸⁷ Net realizable value in this context means estimated sales price reduced by costs of completion and disposal.⁸⁸ If this value is lower than both cost and replacement cost, it is used to reduce the value of the inventory. The difference between this lower net realizable value and the value of inventory as of the inventory date is taken as a loss for the current period.⁸⁹

For example, assume that No-Count Industries had contracts with wholesalers to purchase its entire output. Based on the market for labor and raw materials at the time of contracting, No-Count believed that it could sell the items at the competitive but profitable price of \$85 per unit. Subsequently, the costs of labor and raw materials unexpectedly rose, resulting in the items currently in inventory being produced at a cost of \$100 per unit. For the same reason, No-Count could not reproduce or purchase like items for less than \$100. Assuming that the selling expenses were \$2 per unit, the net realizable value of the inventory would be the estimated sales price less costs of disposition, or \$83. Since this amount was lower than both cost and replacement cost, the items would be so valued for ending inventory purposes. If the items had been carried at

⁸⁵ "Utility value is essentially the profit-producing potential of a product." A.R.S. No. 13, at 24.

⁸⁶ "The support in recent years concentrates more on the rule's usefulness in avoiding overstatement of expected economic benefits through retention of historical cost if the utility value of the inventory items has declined." *Id.* at 101.

⁸⁷ "Market should not exceed the net realizable value (i.e. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal)" A.R.B. No. 43, *supra* note 22, Ch. 4, Stmt 6.

⁸⁸ *Id.*

⁸⁹ See note 80 *supra* for a discussion of this principle.

their unit cost of \$100 up to the inventory valuation date, the result would be a current write-down of \$17.

1. *Establishing the Legitimacy of the
Net Realizable Value Method*

Two decisions, *E. W. Bliss Co. v. United States*⁹⁰ and *Space Controls v. Commissioner*,⁹¹ pioneered the use of the net realizable value method for tax inventory valuation purposes.⁹² Both decisions focused on an analysis of exceptions to the use of bid price as a measurement of market under Treas. Reg. § 1.471-4.

*E. W. Bliss Co. v. United States*⁹³ concerned the valuation of work-in-process consisting of custom-built rolling mills produced under contract to the buyer's specifications. E.W. Bliss valued its work-in-process inventory at the lower of cost or market for tax purposes, but included the accounting profession's net realizable value approach as well.⁹⁴ The court upheld

⁹⁰ *E. W. Bliss Co. v. United States*, 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd*, 351 F.2d 449 (6th Cir. 1965).

⁹¹ *Space Controls, Inc. v. Comm'r*, 322 F.2d 144 (5th Cir. 1963).

⁹² While prior cases found a value less than market sometimes acceptable, this was based on the regulation permitting such valuation for inventory "unsaleable at normal prices or unuseable in the normal way because of damage, imperfections, shopwear, changes of style, odd or broken lots, or other similar causes." Treas. Reg. § 1.471-2(c). See note 34 *supra* for a discussion of that regulation. See, e.g., *Lucker v. U.S.*, 53 F.2d 418 (Ct. Cl. 1931); *C-O-Two Equip. Co. v. Comm'r*, 219 F.2d 57 (3d Cir. 1955). In prior cases the inventory suffered a physical defect or undesirability. However, in *Bliss* and *Space Controls* the goods were physically acceptable. It is the valuation of physically acceptable goods with which we are concerned because in such instances the attempt is, through proper tax planning, to decrease the value of inventory which has gone through no physical change or deterioration. Thus, it is with such physically acceptable inventory that the taxpayer may truly take advantage of inventory valuation. Through use of the net realizable valuation method he may be able to lower the value of ending inventory without a concurring decrease in quality or acceptability.

⁹³ 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd*, 351 F.2d 449 (6th Cir. 1965). It should be noted that *Bliss* was decided under Treas. Reg. § 111-29.22(c)4 of the 1939 Code but the wording of that statute was repromulgated in Treas. Reg. § 1.471-4 of the 1954 Code. For comparison with *Space Controls*, reference is made to the latter.

⁹⁴ At the end of 1951 plaintiff computed the value of its inventory of work in process on the basis of cost or market whichever was lower, as permitted by Regulation 111-29.22(c)2. The method adopted was to accumulate all direct costs of each job more than 50% complete. To this amount was added the estimated cost of completion. The total cost of each press as thus determined was then compared with the sale price of presses manufactured

the taxpayer's use of this method based on its interpretation of the predecessor of Treas. Reg. § 1.471-4.

While the court acknowledged that bid price was the proper valuation approach under "ordinary circumstances and for normal goods in an inventory,"⁹⁵ it found that the goods manufactured by Bliss were not normal goods.⁹⁶ Normal goods were defined as goods of a common type or pattern which are essentially alike in design, size and function and are offered to the public at substantially the same price per item.⁹⁷ The custom-built presses did not fit such a definition because they were unique and were manufactured according to the specifications of the purchaser.⁹⁸ The court then applied the first sentence of

at Canton, Ohio, less an allowance of 15% for gross profit margin and the sale price of presses manufactured at Toledo, less a gross profit margin of 20%. If the projected cost of a completed press exceeded 80 or 85% of the sales price, the excess was eliminated from the inventory and the resulting reduced value represented the market value of the inventory as of the end of the current year.

224 F. Supp. at 376.

⁹⁵ "The definition of market value in Regulation (c) 4 is by its terms applicable only in 'ordinary circumstances and for normal goods in an inventory'." *Id.* at 378.

⁹⁶ While the goods were not "normal" goods, they were physically acceptable, thus not classified under the regulation for subnormal goods: "The abnormal items in plaintiff's inventory are to be distinguished from goods described in Reg. 11-1939 code, § 29.22(c)(2) [Treas. Reg. § 1.471-2(c)'s predecessor] as being unsalable at normal prices or unsalable because of damage or imperfections, etc. — the latter are subnormal rather than abnormal goods." *Id.* at n.1.

⁹⁷ The *Bliss* court defined "normal" as follows:

"Normal" derives from the word "norm" which means "A rule or authoritative standard; model type; pattern." (Webster's New International Dictionary, 2nd ed.). According to the same lexicographer, the word "normal" means — "According to, constituting, or not deviating from, an established norm, rule, or principle; conformed to a type, standard, or regular form; performing the proper functions; not abnormal; . . ." The presses manufactured by the plaintiff at its Hastings plant are normal goods. They conform to a common type or pattern. Each press manufactured at that plant is essentially the same in design, size and function and is offered to the public generally at the same price. Mass production methods can be and are employed in the manufacture of presses at the Hastings plant.

224 F. Supp. at 378.

⁹⁸ The presses manufactured at the Toledo and Canton plants are radically different. They are not of a standard or common type but are of unique and unusual design, extraordinary dimensions and are manufactured according to the specifications of the purchaser. Each of these custom built presses, some of which are four stories in height, are distinctive and they cannot appropriately be characterized as normal goods. The items in plaintiff's

Treas. Reg. § 1.471-4(b)'s predecessor to these abnormal goods.⁹⁹ No open market existed for the goods because, due to their exacting specifications, they were of no real value to anyone but the contracting purchaser.¹⁰⁰ Under such circumstances, market is to be determined by "such evidence of a fair market price at the date or dates nearest the inventory date as may be available."¹⁰¹ The court determined that the net realizable value approach used by the taxpayer was an appropriate method of valuation.

The *Bliss* court permitted the use of net realizable value as a substitute for market value under circumstances where market value could not reasonably be determined.¹⁰² This situ-

inventory of work in process are abnormal.

Id. (footnote omitted).

⁹⁹ "[T]he absence of 'normal goods' in the inventory of goods in process is sufficient to exclude such goods from the definition of 'market' in Reg. (c)4. Plaintiff may, therefore, 'use such evidence of fair market price at the date or dates nearest the inventory as may be available.'" *Id.* at 379. See note 70 *supra* for the text of Treas. Reg. § 1.471-4(b) (1958).

¹⁰⁰ 224 F. Supp. at 379.

¹⁰¹ *Id.*

¹⁰² See notes 75-77 *supra* and accompanying text for a discussion of the definition of market value. The *Bliss* decision is weakly written on this point. The court appears to first attempt use of the purchase price method to determine market value for the goods in process. See note 76 *supra* for a discussion of that method. However, because of the uniqueness of the goods, they could not be purchased in any saleable form by E.W. Bliss: "It is obvious that there can be no open market for a partially finished press built to the specifications of a particular purchaser who is bound by a firm contract to accept and pay a stipulated price for the press when completed and delivered." 224 F. Supp. at 379. Since market could not be determined by the amount the taxpayer would expend to purchase the work in process, the next step should have been to attempt utilization of the reproduction method of market value. See note 77 *supra* for a discussion of the reproduction method. The *Bliss* Court seemed to ignore the reproduction method of determining market value of the inventory.

It is not clear, however, whether an open market exists for all of the basic elements of material, labor and burden of goods in process. Be that as it may, . . . the absence of "normal goods" in the inventory of goods in process is sufficient to exclude such goods from the definition of "market" in Reg. (c)4.

[Treas. Reg. § 1.471-4's predecessor].

Id. Later in the opinion, however, expert testimony presented by Bliss was discussed. *Id.* at 380-82. This testimony was used by the court to conclude that it was "impracticable to compute the replacement or reproduction cost of the partially finished presses here in question." *Id.* at 382. Thus, at one juncture the court seems to ignore the reproduction method of determining market and at another point consider it, but find that its computation in the particular instance would be too impractical and difficult to require its use.

ation, however, is the exception, not the rule. In most cases inventory will consist of common, generally marketable goods for which the bid price can be determined.¹⁰³ Only rarely does inventory consist of items built specifically for the buyer, thereby having no general open market for calculating market value. Thus, for normal goods, bid price must be used as the measure of market value;¹⁰⁴ net realizable value is permissible only where the items are "abnormal."¹⁰⁵

In *Space Controls v. Commissioner*,¹⁰⁶ however, the court held even more broadly that inventory for tax purposes could be valued at net realizable value despite the ability to determine bid price. In *Space Controls*, the taxpayer had a contract with the federal government to produce military trailers which were not suitable for commercial or civilian use. Upon discovering that the estimated total cost to produce the items was in excess of the contract price, the taxpayer wrote down the items to their net realizable value.¹⁰⁷

Since bid price, in the form of replacement or reproductive costs, was ascertainable, the taxpayer could not apply the "no reliable, active market" exception utilized in *Bliss*. Instead, the court upheld the taxpayer's use of net realizable value based on the second segment of Treas. Reg. § 1.471-4(b), which provides: "Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than [bid price], the inventory may be valued at such prices less direct

¹⁰³ The testimony of Mr. Carmen Blough, an accounting expert, was incorporated into the *Bliss* opinion. It was his opinion that it would be impracticable to determine the cost of reproducing or replacing the partially finished presses in the inventory.

He testified that the contrary would be true as to the products of the great majority of the manufacturing corporations in this country which are engaged in mass production of industrial products. As to the latter, Mr. Blough asserted that such companies engage in manufacturing repetitively certain products and would be able through standardized costs to determine reproduction or replacement value of such products when partially completed. He stated in substance, however, that in the case of large custom jobs manufactured in accordance with specifications supplied by the purchaser, it would be difficult and impracticable to ascertain the replacement or reproduction cost of such partially finished products.

Id. at 381.

¹⁰⁴ Treas. Reg. § 1.471-4(a) (1958); 224 F. Supp. at 379.

¹⁰⁵ 224 F. Supp. at 379.

¹⁰⁶ 322 F.2d 144 (5th Cir. 1963).

¹⁰⁷ *Id.* at 145-47.

cost of disposition."¹⁰⁸ The *Space Controls* court felt that the regulatory language should control since the contract was a sale in the regular course of business and the price fixed by the contract was less than the bid price.¹⁰⁹

Thus, according to *Space Controls*, when a taxpayer subject to a fixed price contract is able to foresee that the contract will result in a loss, he may use the net realizable value approach. The "anticipated loss" on each item in inventory may thus be taken in the year the loss becomes evident, rather than the period in which it is finally realized.

2. *Defining the Boundaries of the Net Realizable Value Method: Thor Power Tool Co. v. Commissioner*

Despite the decisions in *Bliss* and *Space Controls*, the net realizable value approach has not been greatly utilized. The primary reason for this disuse, of course, is that the facts presented in those two cases are applicable to only a small percentage of inventory taxpayers. However, both cases left questions regarding the scope of the net realizable value approach which could preclude its use by cautious taxpayers. Many of these scope questions may now be resolved after the recent Supreme Court decision of *Thor Power Tool Co. v. Commissioner*.¹¹⁰

In *Thor*, the taxpayer was a manufacturer of small power tools, parts and accessories. When manufacturing replacement parts, Thor would produce liberal quantities because prediction of the demand for replacement parts was difficult and

¹⁰⁸ Treas. Reg. § 1.471-4(b) (1958).

¹⁰⁹ The Taxpayer's theory satisfies both the letter and the spirit of this Regulation. The contract calling for manufacture, sale and deliver of the trailers was "in the regular course" of its business. It is now conceded, indeed the Tax Court found, that the price for which Taxpayer had "offered for sale such merchandise" was \$360.20 "lower than the current price as above defined." The "current price as above defined" both as to finished goods on hand (16 trailers) and goods in process included the "basic elements of cost" comprising materials, labor, and burden. Whether these are to be determined on "replacement" or "reproductive" costs, the record is uncontradicted and the Tax Court has found that such costs exceeded by \$360.20 the realizable sales price. Likewise this treatment conforms to the best accounting practice which, by statute and regulation, is the generally accepted standard.

Id. at 151. (footnotes omitted).

¹¹⁰ 99 S. Ct. 773 (1979), aff'g, 563 F.2d 861 (7th Cir. 1977), aff'g, 64 T.C. 154 (1975).

additional production runs would require costly retooling and delay. Thor's management believed that its inventory of replacement parts contained more parts than reasonably foreseeable demand dictated and accordingly attempted to reduce the value of its inventory.¹¹¹

In considering revaluation, management determined that it would be impractical to attempt to determine just how many items exceeded demand due to the large quantities and small individual values of the parts in inventory. Instead, management merely estimated the amount of inventory in excess of anticipated demands. Using 1964 sales data to compute the amount of demand in subsequent years, Thor applied an aging schedule with corresponding write-down percentages to the parts inventory.¹¹² At plants where 1964 data was not available the company employed flat percentage write-downs.¹¹³

This rather arbitrary method of valuation was rejected by the Court. It held that while the items may have been truly in excess of future demand, that did not constitute an exceptional circumstance permitting their market valuation to be less than replacement cost.¹¹⁴ By the *Bliss* standard these items were normal goods and Thor could not take advantage of valuation at net realizable value. Likewise, Thor did not meet the *Space Controls* requirement that the goods be offered for sale at less than bid price. The Court further rejected the taxpayer's contention that a valuation method meeting generally accepted accounting principles should be presumed to clearly reflect income. The Court also cited the lack of objective evidence presented to substantiate the value attached to the inventory.

Thor argued that Treas. Reg. § 1.446-1(a)(2) created a presumption that a method clearly reflected income if it conformed to generally accepted accounting principles.¹¹⁵ The

¹¹¹ *Id.* at 777-78.

¹¹² Thor . . . applied the following aging schedule: the quantity of each item corresponding to less than one year's estimated demand was kept at cost; the quantity of each item in excess of two years' estimated demand was written off entirely; and the quantity of each item corresponding to from one to two years' estimated demand was written down by 50% or 75%.

Id. at 778.

¹¹³ The write-downs were 5%, 10% and 50% for the different types of inventory.

Id. at 779.

¹¹⁴ *Id.* at 783.

¹¹⁵ *Id.* at 784-85.

Court agreed that the taxpayer's method conformed to generally accepted accounting principles, but still refused to find that the method clearly reflected income. It held that the taxpayer's claimed presumption was "insupportable in light of the statute, the Court's past decisions, and the differing objectives of tax and financial accounting."¹¹⁶

The *Thor* Court emphasized the language of Treas. Reg. §1.446-1(a)(2) which reads "will ordinarily be regarded as clearly reflecting income" to support its position. While finding that "in most cases, generally accepted accounting practices will pass muster for tax purposes,"¹¹⁷ the Court recognized that in certain instances they would not. When the Commissioner in his discretion determines that they do not "pass muster" he can authorize an alternate practice without having to rebut a presumption in favor of the taxpayer. The Commissioner can accept the accounting profession's endorsement of an accounting practice and still determine that the practice does not clearly reflect income.

The Court emphasized that *Thor* presented no objective evidence that the goods in excess of demand had the market value attributed to them by management. Specifically, the Court noted:

Thor's management simply wrote down its closing inventory on the basis of a well-educated guess that some of it would never be sold. The formulae governing this write-down were derived from management's collective "business experience"; the percentages contained in those formulae seemingly were chosen for no reason other than that they were multiples of five and embodied some kind of analogical symmetry. The Regulations do not permit this kind of evidence."¹¹⁸

To permit such subjective valuation would enable the taxpayer "to determine how much tax it wanted to pay for a given year."¹¹⁹

¹¹⁶ *Id.* at 785.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 783.

¹¹⁹ *Id.* (citing the Tax Court's decision below, 64 T.C. 154, 170 (1975)).

D. *The Net Realizable Value Method After Thor*

While *Thor* did not delineate specifically the scope of the net realizable value approach for tax purposes, it provided general guidelines to resolve that issue.

1. *The Use of the Net Realizable Value Method in Cases Not Involving Fixed Price Contracts*

One question left unresolved by *Bliss* and *Space Controls* was the degree of objectivity required in measuring the future sales price used in the net realizable value method. Both *Bliss* and *Space Controls* involved inventory subject to a fixed price contract. Since both taxpayers were required to sell the goods in process at a fixed price, there was an objective measure of the future sales price. The taxpayer could not change the sales price merely because production was more costly than originally expected. With a fixed price, the point at which production of the item yielded a loss was definite and certain, providing reliable objectivity in the valuation formula.

Most manufacturers, however, do not produce their merchandise subject to fixed sales price contracts. Instead, price varies with demand and the costs of production. Under such circumstances, determining the net realizable value of goods in process requires not only an estimation of future costs of completion but also an estimation as to future sales price. Taxpayers' attempts to estimate these values could violate the objectivity mandate of *Thor*.

Note that Treas. Reg. § 1.471-4(b) requires an objective measurement of the sales price before net realizable value may be utilized.¹²⁰ In *Thor*, the Court noted that *Space Controls* was distinguishable because the goods involved there were subject to a fixed sales price.¹²¹ The goods in *Thor* were not, and the Court found that such an objective measurement of sales price would be required before Treas. Reg. § 1.471-4(b)'s second sentence would be applicable.¹²²

It is likely that the IRS will strictly require an objective measurement of sales price before the net realizable value ap-

¹²⁰ See note 70 *supra* for the text of Treas. Reg. § 1.471-4(b) (1958).

¹²¹ 99 S. Ct. 773, 783 n.13 (1979).

¹²² *Id.*

proach will "clearly reflect income" for tax purposes. Despite these restrictions, the tax benefits are apparent for those who use the net realizable value approach for valuing work-in-process inventory. Thus, even where the taxpayer is not subject to a fixed price contract, he could utilize the method if the estimated future sales price may be demonstrated with reasonable certainty.

Such was the case in *St. James Sugar Cooperative, Inc. v. United States*.¹²³ In *St. James*, the taxpayer had a contract to sell all of its processed raw sugar to Colonial Sugars Company. The sales price was "the simple average of each official daily quotation of the Louisiana Sugar Exchange for the calendar month in which the sugar was loaded onto a barge for delivery to Colonial."¹²⁴ While the price was to be determined by an ascertainable standard, there was no fixed, stated price as was true of the *Bliss* and *Space Controls* contracts. At the end of *St. James'* taxable year the sugar market was on the decline. Because of these falling market prices and its contractual agreement with Colonial Sugars, the taxpayer felt it would not receive the current price quotation of \$27.47 per cwt. Based on the market trend and its knowledge of the trade, *St. James* estimated a sales price of \$17.07 per cwt. and designated it as the "net realizable value."¹²⁵

St. James relied upon *Thor* and the "offering for sale at price lower than bid price" exception found in Treas. Reg. § 1.471-4(b) to justify this deviation from the rule that "market" equals current bid price. The Court agreed, stating that "*St. James* complied with the rule by providing evidence of its actual sales which was actually at \$17.88 per cwt."¹²⁶ Thus the taxpayer demonstrated that its estimate of future sales price at the time of valuation was reasonably accurate, based on subsequent actual sales. This estimate was held to satisfy the objectivity requirement of *Thor*, thus permitting use of the net realizable value method of inventory valuation even where a fixed price contract was not involved.

¹²³ 79-2 U.S.T.C. 87,719 (E.D. La. 1979).

¹²⁴ *Id.* at 87,720.

¹²⁵ *Id.*

¹²⁶ *Id.* at 87,722.

It is interesting to note that the sugar in *St. James* had been fully processed at the time of inventory valuation. Therefore, the only possible subjective element of the net realizable value formula was the estimated future sales price of the sugar. Cost of the completed item was known. This situation is the inverse of the *Bliss* and *Space Controls* computations where the future sales prices were known but the future costs of completion had to be estimated.¹²⁷ Whether the *St. James* decision adds an additional subjective element to the net realizable value formula [i.e. estimated sales price] or merely allows one of these two elements, in the alternative, to have a subjective flavor is subject to future judicial determination. However, it seems clear that at least one element of the net realizable value formula may involve subjectivity so long as there is adequate evidence to demonstrate that the estimation was a reasonable one.

2. *Resolving the Conflict Between Bliss and Space Controls: Whether or Not to Include an Allowance for a Reasonable Profit Margin*

Another difficulty with the formulas used in *Bliss* and *Space Controls* for valuing work-in-process under the net realizable approach is that the formulas are inconsistent. In *Space Controls*, work-in-process was valued at its future sales price minus the costs of completion and disposition.¹²⁸ Since this

¹²⁷ See notes 128 to 132 *infra* for detailed analysis of the *Bliss* and *Space Controls* formulas.

¹²⁸ 322 F.2d 144, 145-47 (5th Cir. 1963).

Although the language in *Space Controls* is vague, this is the formula which the court seems to accept. *Space Controls* determined that the total cost to complete the trailers would be \$1,164.41 per unit and that these units would be sold for the contract price of \$804.21. 322 F.2d at 147 n.9. This resulted in "excess costs," or a loss, of \$360.20 per unit. *Id.* at 147. A write-down was taken to the extent of excess costs. *Id.* at 147 n.7. This was accomplished by reducing the work in process up to that point of production by the "excess of cost over market," or \$360.20. *Id.* The court felt that the Regulations sustained the taxpayer's approach, *id.* at 148, based on Treas. Reg. § 1.471-4(b) and the fact that the treatment conformed to generally accepted accounting standards. *Id.* at 151. Treas. Reg. § 1.471-4(b) and A.R.B. No. 43, *supra* note 22, at Statement 6, state the formula differently from the method of computation used by *Space Controls'* accountants, but they are fundamentally the same and reach the same results as did the *Space Controls* Court.

Treas. Reg. § 1.471-4(b) permits valuation at "sales price less costs of disposition."

value was less than both cost and replacement cost of the work-in-process as of the inventory date, net realizable value was used.¹²⁹ The difference between the net realizable value and the inventory item's original cost was taken currently as a loss.¹³⁰

To illustrate the *Space Controls* method, assume that No-Count Industries was forced to sell its inventory items at \$85 each. Since these items cost \$100 each to manufacture and several completed units were in its inventory, No-Count decided to discontinue production. However, at the time of their decision there were several items in process which were only half finished. The costs incurred by No-Count in bringing the items to that stage of production was \$50. Rather than lose all the capital investment, No-Count decided to complete those goods and hope for a reduced loss on their sale. No-Count estimated that it would cost an additional \$2 to sell the items in process and \$50 to get them in a salable, finished form. Using the *Space Controls* net realizable value formula, inventory would be valued at the future sales price less costs of completion and disposition, or \$33.¹³¹ This value is used since it is less than the original cost or current replacement cost of work in

For a partially finished item these "costs of disposition" would necessarily include costs of completion, since without a finished product it would not sell at the "contract price." A.R.B. No. 43 more clearly states the formula at "estimated sales price less reasonably predictable costs of completion and disposal."

We have used the Treas. Reg. and A.R.B. formula for simplicity and comparison purposes. The difference is merely algebraic. As an example, assume that the *Space Controls* contract was to sell trailers at \$100 per unit, and that several units were in process with a cost of \$90 up to that point of their production. The *Space Controls* accountants estimated that these units would be produced at a total cost of \$115 or with "excess costs" of \$15. Using the *Space Controls* accountants' computation, the cost of the item in process, \$90, would be reduced by these "excess costs," resulting in the item in process having a value of \$75. Using the Treas. Reg. and A.R.B. approach one would first determine the costs to complete an item in process. This would merely be the difference between the estimated total cost (\$115) and the cost of the item in process up to that point (\$90). Estimated costs to complete would then be \$25. To reach the new inventory value you would reduce the estimated sales price (\$100) by the costs to complete (\$25), thus also resulting in the item in process having the new value of \$75. The difference between the old inventory value (\$90) and the new written-down value (\$75) is the amount of loss taken in the current period. Thus, the formulas are fundamentally the same.

¹²⁹ 322 F.2d at 145-47.

¹³⁰ *Id.*

¹³¹ Sales Price (\$85) less Costs to Complete (\$50) less Costs of Disposition (\$2) equals Net Realizable Value (\$33).

process to that stage of production.¹³² Since the inventory had been valued at \$50 during the period, a loss of \$17 would be incurred in the current period pursuant to the write-down.¹³³

In *Bliss*, the court allowed the taxpayer a more liberal valuation. The method used was similar to that in *Space Controls* except that the anticipated sales price was further reduced by an allowance for a normal profit margin.¹³⁴ Applying this valuation method to the above example involving No-Count Industries, net realizable value would be \$28 if No-Count had a normal profit margin of 5 percent on costs incurred.¹³⁵

The *Space Controls* method of determining net realizable value is the ceiling valuation permitted for market in accordance with generally accepted accounting principles.¹³⁶ The *Bliss* valuation is the floor below which market should not fall pursuant to the same principles.¹³⁷ Unfortunately, the accounting profession provides no further guidelines as to when each of these outer parameters should be used.¹³⁸

The *Thor* Court provided that, while the accounting profession may find it appropriate to set ceilings and floors for valuations, such unrestricted variations have no place in tax law. "Accountants long have recognized that 'generally ac-

¹³² Treas. Reg. § 1.471-4(b) (1958).

¹³³ The difference between the original value (\$50) and the new net realizable value (\$33) is \$17. See note 80 *supra* for cases allowing recognition of an unrealized loss.

¹³⁴ "[T]he market value of the goods in process is ascertained by first determining normal or useful costs of the inventory by deducting a gross margin of profit from the sale price and then eliminating from the actual direct cost of inventory any excess above normal costs." 224 F. Supp. 374, 385 (N.D. Ohio 1963).

¹³⁵ Sales Price (\$85) less Costs to Complete (\$50) less Costs of Disposition (\$2) less Normal Profit Margin (\$5) equals Net Realizable Value (\$28).

¹³⁶ A.R.B. No. 43, *supra* note 22, at Ch. 4, Stmt 6 states:

As used in the phrase lower of cost or market the term market means current replacement cost by purchase or (by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and
(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. (footnotes omitted).

¹³⁷ *Id.*

¹³⁸ See generally, A.R.B. No. 43, *supra* note 22, at Ch. 4, Stmt 6, which provides no guidelines for use of these maximum and minimum valuation limits.

cepted accounting principles' are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions."¹³⁹ These accounting principles permit an assortment of "'reasonable' treatments, leaving the choice among alternatives to management."¹⁴⁰ Such alternatives "are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax."¹⁴¹ The tax system requires a more uniform set of rules to achieve consistency in administration of the system. Thus, while the tax law sometimes delineates alternatives, it also provides guidelines for use of these alternatives. It would be inequitable to allow some taxpayers to value inventory subjectively within such a range as the accounting principles contemplate.

Considering this consistency objective, the valuations of net realizable value used in *Bliss* and *Space Controls* cannot be reconciled. The only factor which might account for the inconsistent treatment is the fact that the courts relied on different parts of Treas. Reg. § 1.471-4 in applying the net realizable value approach. The valuation in *Space Controls* was clearly limited to the formula used because the express regulatory language did not contain a provision for a normal profit margin.¹⁴² However, the regulatory language relied on in *Bliss* contained no formula for the court to apply. Rather, the *Bliss* formula was judicially created.¹⁴³ The difference in formula derivation, however, does not explain the differing applications. To the extent they are inconsistent, *Space Controls* seems to have used the more proper method for tax purposes.

As the *Thor* Court stated: "[F]inancial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than the overstatement of net

¹³⁹ *Thor Power Tool Co. v. Comm'r*, 99 S. Ct. 773, 787 (1979) (footnote omitted).

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² See note 70 *supra* for text of Treas. Reg. § 1.471-4(b) (1958).

¹⁴³ While the *Bliss* court allowed reduction of inventory values by a normal profit margin, 224 F. Supp. at 385, Treas. Reg. § 1.471-4(b) does not include provisions for such an allowance. See note 70 *supra* for the text of the regulation. It should be noted that *Bliss* was decided under Treas. Reg. 111-29.22(c)4 of the 1939 Code. However, it was identical to the language in Treas. Reg. § 1.471-4(b) (1958) and for simplicity, reference is made to the later regulation.

income and net assets'."¹⁴⁴ Therefore, one of the primary goals of financial accounting is to state the value of assets so as to avoid misleading the user as to the actual worth.¹⁴⁵ Accordingly, the taking of an allowance for a normal profit margin would be appropriate in order to properly state the value of these assets. The sales price of an item normally provides for a certain amount of profit; without elimination of that amount when computing net realizable value, the company issuing a financial statement would be overstating the true value of the inventory by this profit margin. Since none of the other methods of valuation require the inclusion of a normal profit margin, it would need to be eliminated when computing net realizable value for financial accounting purposes to prevent a possible overstatement of assets.

The goal of tax inventory valuation, however, is the clear reflection of income, not the clear reflection of assets. "In view of the Treasury's markedly different goals and responsibilities understatement of income is not destined to be its guiding light."¹⁴⁶ By permitting an allowance for a normal profit margin in the net realizable value formula, a loss equal to that allowance is being taken in the current year.¹⁴⁷ Since this loss created no out of pocket costs, either currently or in the future, it is not likely that a true loss was ever realized.¹⁴⁸ Consequently, valua-

¹⁴⁴ *Thor Power Tool Co. v. Comm'r*, 99 S. Ct. 773, 786 (1979)(footnote omitted).

¹⁴⁵ "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect the parties from being misled." *Id.* at 786.

¹⁴⁶ *Id.*

¹⁴⁷ See note 80 *supra* for a discussion of this principle.

¹⁴⁸ In support of its holding that a reduction for a "normal profit margin" was permissible in determining net realizable value of the Bliss inventory, the court relied on evidence showing that a reduction for a "normal profit margin" was recognized by generally accepted accounting principles and by the rules of the New York Stock Exchange. *E.W. Bliss Co. v. United States*, 224 F. Supp. 374, 379-80 (E.D. Ohio 1963). However, both are based on a principle of conservatism to prevent the misleading of financial statement users. The tax law is not based on this principle of conservatism, as is noted in the text of the opinion.

Furthermore, the court seemed to limit its application to instances where each item of work in process "is significantly and materially different from every other item" and where it "would place an undue burden upon [the taxpayer] to be required to ascertain the replacement cost of each unfinished press in inventory." *Id.* at 380. This in itself, however, seems to be no justification of a reduction of the known contract price by a normal profit margin.

tion for tax purposes should not include a normal profit margin allowance.

E. *Potential Future Abuse of the Net Realizable Value Method*

The estimation of future costs to complete work-in-process under the net realizable value approach has a certain potential for abuse. This problem was not addressed in *Bliss* or *Space Controls*, but the potentiality is obvious. The standard net realizable value formula for work-in-process is computed by reducing from the expected sales price the costs of completion and disposition.¹⁴⁹ Since the cost of completion is a future cost, it must be estimated; thus by over estimating costs the taxpayer could reduce the value of his work-in-process to unreasonably low levels and take a current loss. For example, estimating larger costs of completion would be a way of writing a loan via current tax savings.

Such abuse will probably not reach mammoth proportions due to the Commissioner's discretion in determining whether the taxpayer's method of valuation clearly reflects income.¹⁵⁰ The potential for abuse surely will cause the IRS to closely scrutinize inventories of taxpayers who use the net realizable approach. Unreasonable estimates will not clearly reflect income.

When the Commissioner determines that a method of valuation does not clearly reflect income, the burden of proof is on the taxpayer to prove that the Commissioner abused his discretion.¹⁵¹ Thus the burden of proof as to the accuracy of the estimated costs of completion is on the taxpayer. Naturally, estimates of these future costs cannot be precise. There will be variances between the estimated and the actual costs necessary to complete a work-in-process item. However, as in *St. James*, an estimation could be upheld if the determination was reasonably and independently made.

¹⁴⁹ "The term *net realizable value* is described as estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal." A.R.S. No. 13, at 103.

¹⁵⁰ See notes 24-33 and accompanying text *supra* for a discussion of the extent of the Commissioner's discretion.

¹⁵¹ *Id.*

*Thor Power Tool Co. v. Commissioner*¹⁵² impliedly approved that position even though the Court upheld the Commissioner's determination that estimations used by Thor did not clearly reflect income. The *Thor* Court emphasized that the estimations were made by Thor's own executives and were based on general "business experience."¹⁵³ Significance seemed to be attached to the fact that no outside parties or sources were considered in computing the estimate.¹⁵⁴ Since the estimation was subjectively based and without adequate documentation, it was held to be unreasonable.

In the estimated costs for completion context this need for a reasonable and independent estimate might be satisfied by consultation with independent engineers and accountants. Estimates of future costs for materials and supplies could be obtained from suppliers, and estimates of future labor costs, from government wage projections. Estimates reasonably prepared, with adequate documentation, would probably satisfy the necessary requirements for a proper estimation. One way to prevent abuse in the estimation of future costs of completion is to allow a write-down only to the extent that the excess costs are attributable to a stage of production reached as of the inventory date. This method requires a division of expected excess costs into those incurred prior to the inventory date and those expected after the inventory date.

For example, assume No-Count Industries was selling an item in the normal course of business at \$90. The costs incurred in producing each finished item was \$120. Assuming that there were no costs of disposition, the net realizable value would be \$90, resulting in a write-down of \$30 which would be included in the cost of goods sold for purposes of determining taxable income for the period. If there were items in process which had a cost of \$80 up to the stage of production reached as of the inventory date, and the estimated costs to complete were \$40, the estimated total costs of completion would be \$120. Costs would exceed the sales price by \$30 and work-in-process would be reduced accordingly. The result would be a similar

¹⁵² 99 S. Ct. 773 (1979).

¹⁵³ *Id.* at 783.

¹⁵⁴ See note 117 and accompanying text *supra* for a discussion of the requirement of an independent, objective estimate of costs incurred.

\$30 write-down even though with the finished goods all excess costs had been incurred, whereas they probably had not with the work-in-process.

To achieve what would seem to be a more proper allocation of excess costs, only the excess costs attributable to production as of the inventory date should be used in valuing work-in-process. For example, if No-Count Industries could determine that all the excess costs were incurred because of cost overruns as of the inventory date, the whole \$30 could be used to write-down inventory. Likewise, if only \$10 was clearly attributable to overruns as of the inventory date, only \$10 should be used in the write-down. The other \$20 would be attributable to subsequent completion and should be used in writing down inventory in the periods in which those excess costs are actually incurred.

Admittedly, determining the excess costs attributable to the inventory as of the inventory date can sometimes be a difficult task. To make a proper determination, excess costs could be prorated over the period of production, where such costs could not otherwise be demonstrated empirically. Another alternative could be to compute a percentage of the excess costs equivalent to the ratio of costs incurred during the period to the total estimated costs.

If the inventory valuation formulas are read in isolation, inventory taxpayers could misinterpret the *Bliss* and *Space Controls* cases to permit taking the full amount of excess costs. A close review of each fact pattern, however, indicates that both courts applied the net realizable formula to excess costs which already had been incurred. The *Space Controls* court stated:

It is perfectly obvious that the expenditures which caused the inventory to have a cost greater than the contract sales price . . . were made in the year [of inventory valuation] It was, therefore, in no sense an effort to obtain in that year a tax advantage for costs neither spent nor incurred until the following year. That loss was a present, existing, known and established one [at the close of the taxable period]. Its existence and economic impact did not depend

on subsequent events. It was then known that there had already been spent more than could ever be received.¹⁵⁵

Likewise, the *Bliss* court held:

The evidence shows that it is practicable to make an approximately correct estimate of the cost to finish a job more than 50% complete. It is unlikely at that stage of manufacture that the expense of completing the job will involve any excessive cost. The addition therefore of normal costs to complete a job causes no increase in the excessive costs, if any, that were in the inventory at the end of the year. Consequently, . . . the excess is properly attributable to the inventory as of [the inventory valuation date] and eliminated therefrom to determine market value as of [that] date.¹⁵⁶

The language used by the *Space Controls* and *Bliss* courts clearly indicates their concern as to whether any of the excess costs were attributable to future periods. Since all these excess costs were attributable to the stages of production incurred as of the inventory date, all excess costs were permitted as a write-down loss in the current period. Thus, by implication, each court would require that excess costs attributable to future stages of production be written down only when incurred. In any event, courts should refuse to allow a current write-down for excess costs to the extent that they have not been incurred as of the inventory valuation date. To the extent the write-down is disallowed, it should be utilized in the period incurred.

William F. Rigsby

¹⁵⁵ 322 F.2d 144, 155 (5th Cir. 1963) (footnote omitted).

¹⁵⁶ 224 F. Supp. 374, 376-77 (N.D. Ohio 1963).